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FROM WASHINGTON

TO AIG 6006,6007

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POLITICAL ANALYSIS: JAPAN TO REMAIN HEAVILY DEPENDENT ON IMPORTED OIL DESPTE ALTERNATE ENERGY SOURCES

1. SUMMARY: SHAKEN BY THE 1973-74 EMBARGO AND PRICE HIKES JAPAN DURING THE PAST TWO YEARS HAS ATTEMPTED TO REDUCE ITS DEPENDENCE ON MIDDLE EAST OIL SUPPLIERS BY:

- SEEKING TO DIVERSIFY ITS SOURCES OF SUPPLY;
- ACCELERATING EFFORTS TO DEVELOP NEW SOURCES OF OIL WITH JAPANESE INVESTMENTS; AND
- ESTABLISHING LONG-RANGE PLANS TO USE MORE NON-OIL ENERGY

IN IMPLEMENTING THESE POLICIES, THE JAPANESE GOVERNMENT HAS BECOME DIRECTLY INVOLVED IN THE ENERGY DECISION-MAKING PROCESS, IN CONTRAST TO ITS POSTWAR HANDS-OFF APPROACH. IT IS FINANCING FOREIGN EXPLORATION, IS ENCOURAGING REORGANIZATION OF JAPANESE OIL COMPANIES TO MAKE THEM MORE EFFECTIVE, AND IS NEGOTIATING DIRECTLY WITH PRODUCING COUNTRIES TO PURCHASE OIL.

DESPITE THESE EFFORTS, JAPAN IS STILL HEAVILY DEPENDENT ON THE MIDDLE EAST FOR OIL. NO CHEAPER OR MORE READILY AVAILABLE SOURCE HAS BEEN FOUND TO MEET JAPAN'S GROWING REQUIREMENTS AS ITS ECONOMY RECOVERS FROM RECESSION. INVESTMENT IN EXPLORATION ABROAD HAS YIELDED LITTLE. CONSEQUENTLY, JAPAN IS LIKELY TO REMAIN THE DEVELOPED COUNTRY MOST DEPENDENT ON FOREIGN OIL. END SUMMARY

2. GROWTH OF ENERGY DEMAND

DURING 1955-73, JAPAN'S PRIMARY ENERGY CONSUMPTION GREW AT AN ANNUAL AVERAGE OF 11.4 PERCENT, COMPARED WITH 3.8 PERCENT FOR THE US, 4.8 FOR WESTERN EUROPE AND 5.3 FOR THE WORLD AS A WHOLE. SINCE THE INDUSTRIAL SECTOR CONSUMES THE LARGEST SHARE OF JAPAN'S ENERGY, THERE ARE FEW CONSERVATION OPTIONS THAT DO NOT DIRECTLY AFFECT THE COUNTRY'S

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ECONOMIC GROWTH (SEE TABLE 1).

TABLE 1. ENERGY CONSUMPTION BY SECTOR IN JAPAN AND THE US
-- (AS PERCENT OF TOTAL CONSUMPTION)

SECTOR	JAPAN		US	
	1953	1973	1953	1973
HOUSEHOLD AND COMMERCIAL			23.0	19.6
INDUSTRIAL	59.3	57.1	41.9	35.2
TRANSPORTATION		16.6	12.9	24.7
NON-FUEL (E.G., PETROCHEMICALS)		1.1	10.4	4.0
MISCELLANEOUS		--	--	2.6
				0.3

3. PATTERN OF ENERGY SUPPLY

ALTHOUGH JAPAN IS NOT WELL ENDOWED WITH INDIGENOUS ENERGY RESOURCES, IT MET MOST OF ITS POSTWAR NEEDS DOMESTICALLY UNTIL THE MID-1950'S. THE LARGEST SHARE OF ITS REQUIREMENTS WAS SUPPLIED FROM DOMESTIC COAL DEPOSITS (SEE TABLE 2). THIS PATTERN BEGAN TO CHANGE WHEN JAPAN BEGAN DEVELOPING THE HEAVY INDUSTRIES THAT HAVE LED ITS INDUSTRIAL GROWTH. AS SUCH LARGE ENERGY-CONSUMING INDUSTRIES AS STEEL, NON-FERROUS METALS, PETROCHEMICALS AND SYNTHETIC FIBERS DEVELOPED, JAPAN SHIFTED FROM HIGH-PRICED DOMESTIC

COAL TO CHEAPER IMPORTED OIL. IN 1958 THE GOVERNMENT ADOPTED AN ENERGY POLICY THAT REMOVED IMPORT CONTROLS ON CRUDE OIL AND INTRODUCED A COAL RATIONALIZATION PROGRAM DESIGNED TO REDUCE THE PRICE OF COAL.

TABLE 2. JAPAN: PATTERN OF ENERGY SUPPLY
-- (MILLION METRIC TONS OF COAL EQUIVALENT)

-- PCENT PCENT PCENT PCENT
-- 1955 TOTAL 1960 TOTAL 1965 TOTAL 1970 TOTAL

DOMESTIC SOURCES

COAL 43.2 65.7 53.9 49.6 47.4 27.2 39.1 11.8

OIL 4.0 6.1 2.8 2.6 6.2 3.6 5.8 1.7

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NATURAL GAS 0.2 0.3 1.0 0.9 2.6 1.5 3.5 1.1

HYDRO AND

NUCLEAR 6.0 9.1 7.4 6.8 8.9 5.1 10.6 3.2

IMPORTS

COAL 2.9 4.4 8.3 7.6 17.1 9.8 50.3 15.1

OIL 9.5 14.4 35.2 32.4 92.3 52.9 221.4 66.6

NATURAL GAS - - - - - - 1.7 0.5

TOTAL 65.8 108.6 174.5 332.4

A. GROWTH OF OIL IMPORTS.

THE COMPARATIVELY LOW AND DECLINING PRICE OF OIL ENCOURAGED JAPAN TO TURN TO IMPORTED OIL TO FUEL ITS INDUSTRIAL EXPANSION. DURING 1955-70, THE AVERAGE ANNUAL INCREASE IN JAPANESE OIL IMPORTS EXCEEDED 23 PERCENT, THUS CONSTITUTING ABOUT 80 PERCENT OF JAPAN'S GROWTH IN ENERGY CONSUMPTION DURING THE PERIOD. BY THE EARLY 1970S, JAPAN WAS ABSORBING 15 PERCENT OF TOTAL WORLD OIL EXPORTS. THROUGHOUT, THE GOVERNMENT FOLLOWED A LARGELY NON-INTERVENTIONIST POLICY WITH

REGARD TO ENERGY, IN SHARP CONTRAST TO THE TIGHT CONTROL IT MAINTAINED OVER IMPORTS OF CONSUMER GOODS, CAPITAL AND TECHNOLOGY.

B. SOURCES OF OIL

SINCE 1960, MIDDLE EASTERN COUNTRIES HAVE ACCOUNTED FOR 70-90 PERCENT OF JAPAN'S OIL IMPORTS (SEE TABLE 3). CURRENTLY, NEARLY HALF OF ITS TOTAL IMPORTS COMES FROM ARAB COUNTRIES. IMPORTS FROM INDONESIA SINCE 1960 HAVE BEEN RELATIVELY CONSTANT, AVERAGING ALMOST 12 PERCENT. CHINA HAS EMERGED AS A NEW, THOUGH STILL MINOR, SOURCE OF OIL.

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TABLE 3. JAPAN: SOURCES OF CRUDE OIL IMPORTS
-- (PERCENT OF TOTAL)

COUNTRY	1960	1965	1970	1973	1974	1975
---------	------	------	------	------	------	------

KUWAIT /A	43	41	19	11	10	9
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SAUDI ARABIA	18	19	15	27	27	29
UNITED ARAB EMIRATES	--	--	--	5	9	9
IRAQ	14	7	--	--	--	--
IRAN	4	21	44	34	26	25
INDONESIA	11	7	12	14	14	12
USSR	4	3	--	/B	/B	--
CHINA	--	--	--	/B	1	4
OTHER /C	6	2	5	9	11	12

/A - INCLUDES NEUTRAL ZONE

/B - LESS THAN 1 PERCENT

/C - MAY INCLUDE SMALL AMOUNTS FROM ABOVE COUNTRIES WHEN

--- THESE WERE TOO SMALL IN A PARTICULAR YEAR TO BE SEPAR-

--- RATELY LISTED BY COUNTRY.

4. IMPACT OF THE 1973-74 EMBARGO AND PRICE INCREASES

LIKE OTHER INDUSTRIAL COUNTRIES, JAPAN SAW LITTLE DANGER IN ITS HEAVY DEPENDENCE ON MIDDLE EASTERN OIL. THE WORLD SUPPLY OF OIL WAS ASSUMED TO BE RESPONSIVE TO INCREASING DEMAND, AND JAPAN RELIED ON ITS GROWING EXPORT COMPETITIVENESS TO PAY FOR ITS FUTURE IMPORT REQUIREMENTS. NO FOREIGN OIL SUPPLIER APPEARED LIKELY TO JEOPARDIZE ITS SHARE OF THE WORLD'S LARGEST AND FASTEST GROWING IMPORT MARKET. JAPAN ALSO SAW THE LARGE US DOMESTIC OIL SUPPLY AND THE FOREIGN OPERATIONS OF THE US OIL COMPANIES AS ASSURANCES OF CONTINUED SUPPLY SECURITY.

THE EVENTS OF 1973 SHATTERED THESE ASSUMPTIONS, FORCING JAPAN TO REAPPRAISE ITS ECONOMIC GROWTH PROSPECTS, ITS LONG TERM ENERGY REQUIREMENTS, AND ITS IMPORT-DEPENDENCE. THE

OIL CRISIS HIT JAPAN WHEN IT STILL WAS ADJUSTING TO THE DOLLAR DEVALUATION AND THE APPRECIATION OF THE YEN AND COMBATING DOUBLE-DIGIT INFLATION. THE COMBINATION PLUNGED JAPAN INTO ITS WORST POSTWAR RECESSION.

THE OIL PRICE INCREASE AND THE MEASURES DESIGNED TO COPE WITH IT ARE ESTIMATED BY ECONOMIST TSUNEHICO WATANABE (IN EDWARD R. FRIED AND CHARLES L. SCHULTZE /EDS./, "HIGHER OIL PRICES AND THE WORLD ECONOMY," BROOKINGS, 1975, PP 143-168) TO HAVE CAUSED JAPAN'S REAL GNP IN 1974 TO DROP 9.4 PERCENT
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FROM WHAT IT MIGHT OTHERWISE HAVE BEEN; 5.4 PERCENT OF THE REDUCTION WAS ATTRIBUTED DIRECTLY TO THE OIL PRICE INCREASE. PRICES JUMPED 20 PERCENT, AND THE DEFICIT IN THE CURRENT BALANCE CLIMBED TO \$7.2 BILLION.

5. ENERGY POLICY

ENERGY POLICY IN JAPAN TRADITIONALLY HAS BEEN THE RESPONSIBILITY OF THE MINISTRY OF INTERNATIONAL TRADE AND INDUSTRY (MITI), THE AGENCY PRINCIPALLY ENTRUSTED WITH JAPAN'S POST WAR INDUSTRIAL DEVELOPMENT. A 1962 PETROLEUM LAW EMPOWERED MITI TO RATION PERMITS FOR THE REFINERY AND SALES OPERATIONS OF DOMESTIC OIL FIRMS. IN DECEMBER 1973, THE PETROLEUM SUPPLY ADJUSTMENT LAW AND THE NATIONAL LIVELIHOOD STABILIZATION LAW WERE PASSED WHICH STRENGTHENED MITI'S ROLE AND GAVE IT AUTHORITY TO SET PETROLEUM PRODUCT PRICES IN JAPAN.

BECAUSE FINANCIAL AND FOREIGN POLICY CONSIDERATIONS HAVE BECOME MAJOR FACTORS, MITI IS NO LONGER PREEMINENT IN THE FORMULATION OF ENERGY POLICY. PRIME MINISTER MIKI HAS FORMED AND CHAIRS A COUNCIL OF ALL THE MAJOR CABINET MEMBERS -- THE MINISTERIAL COUNCIL ON COMPREHENSIVE ENERGY POLICY -- TO DECIDE ENERGY POLICY. ENERGY POLICIES RECENTLY INSTITUTED BY THE COUNCIL INCLUDE:

(A)--DIVERSIFYING THE SOURCES OF OIL;

(B)--DEVELOPING DIRECT ACCESS TO SOURCES OF CRUDE OIL BY STRENGTHENED JAPANESE-CONTROLLED OIL COMPANIES;

(C)--EXCHANGING JAPANESE CAPITAL AND TECHNOLOGY FOR ASSURED ACCESS TO CRUDE OIL;

(D)--RESTRUCTURING THE ECONOMY AT LOWER ENERGY INTENSITY, INCLUDING THE EXPORT OF ENERGY-INTENSIVE INDUSTRIES;

(E)--STOCKING EMERGENCY SUPPLIES OF FUELS TO DEAL WITH POSSIBLE FUTURE OIL IMPORT DISRUPTIONS;

(F)--DEVELOPING NEW SOURCES OF ENERGY, INCLUDING NUCLEAR

POWER, SOLAR ENERGY, GEOTHERMAL ENERGY, AND COAL-BASED SYN-
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THETIC FUELS;

(G)--JOINING WITH OTHER INDUSTRIAL COUNTRIES TO DEVISE COM-
MON PROGRAMS FOR ENERGY CONSERVATION AND RESEARCH AND DE-
VELOP NEW ENERGY SOURCES; AND

(H)--PROMOTING BILATERAL AND MULTILATERAL CONSULTATION
AMONG INDUSTRIAL, DEVELOPING, AND OIL-PRODUCING COUNTRIES
AND MULTINATIONAL OIL COMPANIES ON SUPPLY ACCESS AND PRICE
STABILITY.

6. LONG-TERM CHANGES IN ENERGY SUPPLY PATTERN

LONG-TERM ENERGY PLANS RECENTLY ANNOUNCED BY THE COUNCIL
CALL FOR REDUCING JAPAN'S OIL IMPORTS FROM 77 PERCENT OF
ENERGY CONSUMPTION IN 1973 TO 63 PERCENT IN 1985 (SEE TABLE
4). EVEN SO, THE SHARE REPRESENTED BY DOMESTIC SOURCES
WOULD FALL FROM 9.5 PERCENT TO 8 PERCENT OF TOTAL ENERGY
SUPPLY. THE FASTEST GROWTH WOULD BE IN NUCLEAR POWER, A
SEMI-DOMESTIC SOURCE. LIQUIFIED NATURAL GAS (LNG) IMPORTS
ARE ALSO EXPECTED TO RISE DRAMATICALLY.

NUCLEAR POWER IS CONSIDERED A SEMI-DOMESTIC ENERGY SOURCE
IN THE SENSE THAT (1) NUCLEAR FUEL PROVIDES A STABLE, LONG
LASTING SOURCE OF ENERGY ONCE IT IS IMPORTED; AND (2) FUEL
COSTS ARE ONLY A SMALL PART OF TOTAL COSTS, MOST OF WHICH
WILL BE DOMESTIC. GIVEN THE STRONG POLITICAL INHIBITIONS
ABOUT NUCLEAR POWER IN JAPAN, THE NUCLEAR GOAL WILL BE
HARD TO MEET.

ALTHOUGH THE SHARE OF OIL IN TOTAL EMERGENCY CONSUMPTION IS
SCHEDULED TO DECLINE, THE ACTUAL VOLUME OF IMPORTS IS EX-
PECTED TO RISE FROM 5.5 MILLION B/D IN 1973 TO 8.4 MILLION
B/D IN 1985.

THE ENERGY PLAN DEPENDS HEAVILY ON CONSERVATION EFFORTS BY
HOUSEHOLDS AND INDUSTRIES TO REDUCE CONSUMPTION. BUT THE
QUESTION OF HOW THE COSTS OF ENERGY SAVING PROGRAMS SHOULD
BE SHARED BETWEEN GOVERNMENT AND THE PRIVATE SECTOR IS YET
TO BE DECIDED.

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TABLE 4. JAPAN: LONG-TERM ENERGY SUPPLY-DEMAND PLAN

-- 1973 1980 1985

DEMAND (MILLION B/D OIL EQUIVALENT)

WITHOUT CONSERVATION	7.1	10.3	14.3
WITH CONSERVATION	-	9.6	13.1
CONSERVATION (PERCENT)	-	6.4	9.4

SUPPLY (PERCENT OF TOTAL)

DOMESTIC	(9.5)	(8.1)	(8.0)
HYDROELECTRIC	4.6	4.2	3.7
GEOTHERMAL	0.0	0.1	0.5
OIL AND NATURAL GAS	0.9	1.2	1.8
COAL	3.8	2.5	1.9
NUCLEAR (SEMI-DOMESTIC)	0.6	4.4	9.6

--	1973	1980	1985
----	------	------	------

IMPORTED	(89.9)	(87.5)	(82.4)
LNG	0.8	5.2	7.9
COAL	11.7	13.4	11.2
OIL	77.4	68.9	63.3

NOTE: TOTALS MAY NOT ADD BECAUSE OF ROUNDING

7. OIL FROM CHINA

AS PART OF ITS DIVERSIFICATION EFFORTS, JAPAN IS BUYING SIZABLE AMOUNTS OF OIL FROM CHINA. SUCH IMPORTS TOTALED ABOUT 4 MILLION TONS IN 1974 AND NEARLY 8 MILLION TONS IN 1975 BUT STILL REPRESENTED ONLY ABOUT 4 PERCENT OF JAPAN'S OIL IMPORTS. CHINA HAS BEEN PRESSING FOR A FASTER EXPANSION OF SUCH SALES THAN THE JAPANESE HAVE BEEN WILLING TO ACCEPT. NEGOTIATIONS BETWEEN CHINA AND JAPAN ON A LONG-RUN OIL AGREEMENT ARE STALLED, WITH THE CHINESE UNHAPPY THAT THE JAPANESE HAVE NOT AGREED TO BUY MORE.

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N PROBLEM FOR JAPAN IS THE WAX CONTENT OF CHINESE CRUDE. IN ORDER TO USE LARGE AMOUNTS OF THIS OIL, JAPANESE REFINERIES WOULD HAVE TO MAKE SUBSTANTIAL AND COSTLY MODIFICATIONS. MORE IMPORTANTLY, JAPAN IS RELUCTANT TO REDUCE FURTHER ITS ALREADY RECESSION-CURTAILED IMPORTS FROM INDONESIA AND MIDDLE EAST COUNTRIES BECAUSE IT WANTS TO MAINTAIN GOOD RELATIONS WITH THEM FOR THE FUTURE, WHEN ITS DEMANDS BEGIN TO GROW AGAIN. INDONESIA ALREADY HAS COMPLAINED ABOUT THE JAPANESE CUTBACK IN IMPORTS.

8. OVERSEAS INVESTMENT

JAPAN'S DIVERSIFICATION EFFORTS ALSO INCLUDE DIRECT INVEST-

MENT IN EXPLORATION AND DEVELOPMENT AROUND THE WORLD. ALTHOUGH SUCH ACTIVITY HAS BEEN UNDERTAKEN SINCE 1967, IT IS NOW ASSUMING GREATER URGENCY. A PUBLIC CORPORATION, THE JAPAN PETROLEUM DEVELOPMENT CORPORATION (JPDC), PROVIDES JAPANESE COMPANIES WITH FINANCIAL AND TECHNICAL ASSISTANCE TO PROMOTE DEVELOPMENTAL ACTIVITIES. SO FAR IT HAS INVESTED ABOUT \$660 MILLION IN THE SEARCH BUT HAS HAD LITTLE SUCCESS.

SOME 47 JAPANESE EXPLORATION CONSORTIA HAVE BEEN OPERATING UNDER JPDC SPONSORSHIP. OF THESE, 15 HAVE BEEN EXPLORING IN SOUTH ASIA AND AUSTRALIA, NINE IN THE MIDDLE EAST, EIGHT ALONG THE JAPANESE CONTINENTAL SHELF, FOUR IN NORTH AMERICA, AND THREE EACH IN LATIN AMERICA AND AFRICA. AN EARLY MITI GOAL WAS TO HAVE JAPANESE-DEVELOPED PRODUCTION COVER 30 PERCENT OF TOTAL OIL NEEDS BY 1985. THUS FAR, JAPANESE PRODUCERS ARE BRINGING HOME ONLY ABOUT 12 PERCENT.

9. REORGANIZATION OF JAPANESE OIL COMPANIES

THE INTERNATIONAL OIL COMPANIES SUPPLY MORE THAN 75 PERCENT OF JAPAN'S OIL IMPORTS. THUS, THE JAPANESE FEEL DOUBLE DEPENDENT -- BOTH ON FOREIGN SOURCES FOR OIL AND ON FOREIGN-OWNED FIRMS TO PROVIDE MOST OF IT. TO REDUCE THE LATTER DEPENDENCE, MITI IS URGING A REORGANIZATION OF THE INDEPENDENT JAPANESE OIL COMPANIES. THE CURRENT 18 JAPANESE INDEPENDENTS WERE ESTABLISHED WHEN THE ECONOMY WAS FLOURISHING AND, ALONG WITH THE 21 FOREIGN-AFFILIATED REFINERS AND

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PRIMARY DISTRIBUTORS, MAY NOW BE TOO NUMEROUS FOR ANY OF THEM TO COMMAND SIGNIFICANT BARGAINING POWER. MITI WANTS TO REORGANIZE THESE INDEPENDENTS INTO TWO OR THREE "JAPANESE MAJORS" CAPABLE OF UNDERTAKING THE ENTIRE RANGE OF ACTIVITIES FROM DEVELOPMENT AND IMPORT TO REFINING AND SALES.

MITI PREDICTS THAT REORGANIZATION CAN PROCEED WITHOUT ALTERING THE 50 PERCENT SHARE OF REFINING CAPACITY OWNED BY FOREIGN-AFFILIATED OIL FIRMS. THE FOREIGN AFFILIATES, HOWEVER, FEAR THAT THE GOVERNMENT MIGHT DISCRIMINATE AGAINST THEM IN SUCH MATTERS AS LOCATION AND FACILITY INVESTMENT.

10. OUTLOOK

JAPAN IS THE MOST VULNERABLE MAJOR OIL CONSUMER, AND THERE IS LITTLE IT CAN DO TO REDUCE SIGNIFICANTLY ITS IMPORT DEPENDENCE OVER THE NEXT DECADE. SLOWER ECONOMIC GROWTH AND CONSERVATION MEASURES WILL HELP RESTRICT DEMAND. NUCLEAR POWER WILL PROVIDE SOME SEMI-DOMESTIC ENERGY SUPPLY BUT PROBABLY NOT AS MUCH AS PLANNED. OIL IMPORTS WILL REMAIN

BY FAR THE LARGEST SOURCE OF JAPAN'S ENERGY. GIVEN THE
PRESENT TRENDS OF PARTICIPATION AND NATIONALIZATION IN THE
THIRD WORLD, DIRECT INVESTMENT DOES NOT GUARANTEE SUPPLIES
FROM ANY PARTICULAR COUNTRY. BECAUSE OF THESE CIRCUM-
STANCES, JAPAN MUST CONTINUE TO AVOID CONFRONTATION WITH
THE OIL EXPORTERS.

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